COUNCIL OF
THE EUROPEAN UNION

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LEGISLATIVE ACTS AND OTHER INSTRUMENTS

Subject:	COUNCIL RECOMMENDATION to Latvia with a view to bringing an end to the situation of an excessive government deficit

COUNCIL RECOMMENDATION

of

to Latvia with a view to bringing an end to the situation of an excessive government deficit

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(7) thereof,

Having regard to the recommendation from the Commission, Whereas:

(1) According to Article 104 of the Treaty Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) The 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the excessive deficit procedure ("EDP"). In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

(4) The Council decided on 7 July 2009, in accordance with Article 104(6), that an excessive deficit exists in Latvia.

(5) In accordance with Article 104(7) of the Treaty and Article 3 of Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[1] (which is part of the Stability and Growth Pact), the Council is also required to make recommendations to the Member State concerned with a view to bringing the situation of excessive deficit to an end within a given period. The recommendation has to establish a deadline of six months at the most for effective action to be taken by the Member State concerned to correct the excessive deficit as well as a deadline for the correction of the excessive deficit, which should be completed in the year following its identification unless there are special circumstances. In deciding whether special circumstances exist, "relevant factors" as clarified in Article 2(3) of Regulation (EC) No 1467/97 should be taken into account. Furthermore, in a recommendation to correct an excessive deficit the Council should request the achievement of a minimum annual improvement in the structural balance, that is, the cyclically-adjusted balance excluding one-off and other temporary measures, of 0,5 % of GDP as a benchmark. In deciding whether special circumstances exist, "relevant factors" as clarified in Article 2(3) of Regulation (EC) No 1467/97 should be taken into account.

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[1] OJ L 209, 2.8.1997, p. 6.

(6) Special circumstances, which are relevant for the greater flexibility in the application of the EDP introduced with the 2005 reform of the Stability and Growth Pact, are deemed to exist in the case of Latvia, notably on account of the global financial crisis, which amplified the shock of the reversal of Latvia's own lending and house price boom by sharply tightening credit availability and conditions. The rapid slowdown in Latvia's economy in 2008 came after years of sustained growth, fuelled by booming domestic demand and increasing internal and external imbalances leading to the accumulation of large foreign currency denominated private sector debt stock. Fiscal policy was expansionary throughout the boom period, while monetary and credit conditions tightened in 2008 amid higher country risk perceptions and a continued appreciation of the real effective exchange rate. The concomitant downturn on export markets has hit the tradeables sector, the competitiveness of which had been already weakened by huge domestic cost increases over the previous years. Latvia's financial markets and banking sector came under significant pressure from October 2008 onwards, sparked by difficulties at the largest locally-owned bank (Parex).

The confrontation with an abrupt and severe banking sector and external financing crisis prompted the Latvian authorities to seek international financial assistance at the end of 2008[1]. The agreement in December 2008 on multilateral financial assistance of up to EUR 7,5 bn was conditional on major fiscal consolidation over the period 2009-11 as well as financial system and structural reforms, as also outlined in the "Economic Stabilisation and Growth Revival Programme" adopted by the authorities in December 2008. Subsequently, following a much greater than expected deterioration in economic and budgetary conditions in the first half of 2009, the government adopted in June a revised package of consolidation measures and a multi-annual perspective for reducing the deficit below 3 % of GDP by 2012. Fiscal consolidation is a cornerstone of the adjustment programme anchored to the current currency peg and to the accession to the euro area.

(7) The existence of special circumstances authorises the Council to allow the correction of the excessive deficit in a medium-term framework. Considering the Commission services' spring 2009 deficit forecast for 2009 and 2010, subsequent economic and budgetary developments and the existence of special circumstances, Latvia is recommended to correct the excessive deficit by 2012 at the latest. Against the background of the assessment of the current budgetary position made in the context of the Balance of Payments assistance to Latvia, this would imply an annual average fiscal effort of at least 2¾ percentage points of GDP over the period 2010-2012 and would be consistent with general government deficit targets of no more than 10 % of GDP in 2009, no more than 8,5 % of GDP in 2010 and no more than 6 % of GDP in 2011. In the context of the currency peg arrangement, the timing and composition of measures, including structural measures, necessary to correct the excessive deficit should also reflect the need to deliver macroeconomic stability and to restore competitiveness.

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1 The up to EUR 7,5 bn financing package is jointly funded by the EU, IMF, World Bank, EBRD, Nordic countries, Czech Republic, Estonia and Poland and is provided to Latvia in several instalments up to Q1 2011, in a front-loaded manner.

(8) The Latvian Parliament adopted an amended budget for 2009 on 12 December 2008, subsequently reflected in the January 2009 convergence programme update. In the context of the much deeper than expected deterioration in global and domestic economic conditions, however, implementation of the December 2008 measures was insufficient to prevent by mid-2009 a clear and wide divergence of progress with fiscal consolidation relative to the December 2008 plan, and further measures were urgently needed.
In June 2009, and following agreement with the social partners, the government proposed additional measures for 2009, adopted by Parliament on 16 June, and a revised multi-annual perspective with further cumulative consolidation measures for 2010-12 targeting a reduction in the general government deficit to under 3 % of GDP by 2012. An avowed objective of the June 2009 decisions has been to pave the way for extensive structural reforms in the public sector, notably as regards education and healthcare, to underpin a return to sustainable public finances and competitive economic structure in the medium term.

(9) Achievement of the revised programme is subject to considerable risks. These relate principally to the high uncertainty regarding the impact on Latvia of the global financial crisis and international policy responses to it, the ongoing correction of economic imbalances in Latvia and, given their intended scale and scope, the uncertain impact of the stabilisation measures undertaken in Latvia on the levels of activity, labour market participation and recourse to social protection arrangements, and thus on the overall consolidation path. With the adoption of the revised package of consolidation measures in June, Latvia has shown its resolve to tackle its large fiscal imbalances; continued commitment to implementation and full delivery of the measures is necessary for fiscal and economic recovery to take hold in a sustainable way.

(10) In order to further enhance the credibility of the medium-term consolidation strategy, it will be crucial to address the fragilities of the Latvian budgetary framework. The current medium-term budgetary framework remains rather weak as regards medium-term planning and control of public finances. Therefore, as already recommended in the March 2009 Council opinion on the convergence programme update, risks to the adjustment should be limited by strengthening fiscal governance and transparency, by improving the medium-term budgetary framework and reinforcing Ministry of Finance spending controls.

(11) Although general government gross debt still remains well below the 60 % of GDP reference value (19,5 % of GDP in 2008), it is projected to be on a rapidly growing trend (in the Commission services' spring forecast, rising to 34,1 % of GDP in 2009 and 50,1 % of GDP in 2010, assuming full take-up of the international financial assistance being extended to Latvia during the period up to 2011). Taking account of the new consolidation measures adopted in June 2009 and further consolidation plans indicated by the authorities for 2010-12, and depending on whether and to what extent the government assumes further debt in respect of financial sector stabilisation needs, the gross debt ratio may exceed the 60 % of GDP reference value in 2012, even with sufficient corrective action.

(12) Enhanced surveillance under the EDP, which is necessary in view of the Community medium-term financial assistance made available to Latvia, and also of the deadline for the correction of the excessive deficit, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy. In this context, a separate chapter in the updates of the Latvian convergence programme which will be prepared between 2009 and 2011 could usefully be devoted to this issue.

(13) In general, in the view of the Council, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and promoting structural reforms so as to reinforce the growth potential of the economy. Attention should also be paid to the distributional consequences of the adjustment,

HEREBY RECOMMENDS:

1. The Latvian authorities should put an end to the present excessive deficit situation as rapidly as possible and at the latest by 2012.

2. The Latvian authorities should bring the general government deficit below 3 % of GDP in a credible and sustainable manner by taking action in a medium-term perspective. Specifically, to this end, the Latvian authorities should:

   (a) implement fully the consolidation in 2009 as planned in the supplementary budget adopted by Parliament on 16 June 2009 to reach a general government deficit below 10 % of GDP and swiftly implement additional measures if needed in order to ensure compliance with the commitments undertaken under the balance of payments programme;

   (b) building on the consolidation being implemented in 2009 and so far planned for 2010, adopt a 2010 budget with sustainable measures consistent with this consolidation path and the need to improve competitiveness and implement it rigorously;

   (c) with a view to bringing the deficit below 3 % of GDP by 2012, ensure an average annual fiscal effort of at least 2¾ % of GDP over the period 2010-2012;

   (d) strengthen fiscal governance and transparency, by improving the budgetary framework and reinforcing Ministry of Finance's spending controls, and strengthen financial market regulation and supervision.

3. The Latvian authorities should strengthen the binding nature of the medium-term budgetary framework as well as improve the monitoring of the budget execution throughout the year, including by improving the collection and processing of general government data.

4. The Council establishes the deadline of 7 January 2010 for the Latvian government to take effective action to implement the measures adopted on 16 June 2009, to adopt a fully articulated 2010 budget with high-quality consolidation measures consistent with the envisaged path for the correction of the excessive deficit by 2012 and to broadly outline the measures envisaged for 2011 and 2012 necessary to achieve this path.

5. The Latvian authorities should report on the progress made in the implementation of these recommendations in a separate chapter in the updates of the convergence programme prepared in the period prior to the abrogation of the excessive deficit procedure.

In addition, the Council highlights the importance of achieving the medium-term objective (MTO) for appropriate budgetary management of economic downturns. It therefore invites the Latvian authorities to ensure that, after correction of the excessive deficit, budgetary consolidation is sustained towards the MTO for the budgetary position – a 1 % of GDP deficit in structural terms – through a structural improvement of at least 0,5 % of GDP per year.

This recommendation is addressed to the Republic of Latvia.

Done at Brussels,

For the Council
The President